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April 14, 2013

Comments: Small Business/Pass Throughs Working Group

Dear Representatives Buchanan and Schwartz:

The Small Business Draft provides for two options for reform of the rules relating to the taxation of pass-through entities. My comments address both options.

Option 1 contains changes to the S corporation rules that are long overdue in eliminating tax traps and "gotcha's" that have deprived many taxpayers of the benefit of S corporations due solely to inadvertence. Other S corporation provisions remove some restrictions on qualifying for S corporation status. In particular, the restriction on the ability of a non-resident alien ("NRA") to be a shareholder of an S corporation has been very problematic for many companies. Under current law, if an S corporation desires to acquire NRA equity and maintain pass-through tax treatment, the company must engage in complex restructuring through blockers and non-corporate entities. The proposal to allow non-resident aliens to hold stock through an electing small business trust ("ESBT") is helpful but does not go far enough. The benefit of the proposal would only be available to taxpayers who can plan into NRA ownership and establish an ESBT. The proposal would not help companies that lose S status because of a change in status of a shareholder from a US person to an NRA or the transfer of an interest by a shareholder to an NRA. This is one of the few places in the tax law where one taxpayer's (the S corporation shareholder) tax consequences may be determined by another person (the transferring shareholder). Not only should S corporations be allowed to have NRA stakeholders, the corporation should not be at risk of losing the S election due to the changing status or transfer by one of its shareholders.

The ESBT accomplishes the goal of retaining tax jurisdiction over the share of S corporation income of the NRA, but is itself subject to technical requirements that may not be widely understood or easy to meet. Given the policy concern of taxing NRAs on their share of the S corporation's income, a narrower and more effective approach would borrow from the partnership withholding rules, and require the S corporation to withhold on the NRA's share of effectively connected income and fixed or determinable or periodic income at a statutory or treaty rate. Thus, I suggest that the S corporation itself be subject to the same withholding rules that currently apply to partnerships with foreign partners.

Option 1 also repeals the rules relating to guaranteed payments, in effect allowing partners to be employees. Anecdotally, it is the commentator's experience that the rules prohibiting partners from being employees is so counter intuitive and contrary to the way business is conducted that it is widely disregarded in practice.

Large employee leasing companies have taken the position that partners can be employees under published IRS guidance. In addition, some states do not follow the federal rules on classification of partners and, in fact, require partners to be treated as employees even though they may not be treated as such for federal withholding purposes, creating complexity and confusion in withholding. The proposed change would eliminate a regime that has served little purpose and has burdened rather than benefitted withholding on compensation as an enforcement mechanism.

Option 2 proposes a unified system of taxation of pass-throughs that addresses the concern that different tax treatment may result from the same transaction due solely to choice of entity. The proposal prohibits special allocations, allows allocations only of net (and not gross) income and loss, requires entity level withholding, and requires gain on distributions of appreciated property. Option 2 would repeal well established partnership tax concepts and I oppose Option 2 for the following reasons and in the follow specific respects.

Fundamentally, I disagree with the proposition that a "one size fits all" structure is necessary or appropriate. For very good corporate and tax reasons, each of the S corporation, C corporation and partnership tax structures have qualities that fit certain businesses. At its core, some businesses are more properly conducted through an "entity" (the entity is a separate tax or reporting vehicle whose interests are separate from its owners) whereas others are more properly conducted as an "aggregate" (the entity is a relationship among its owners which pools or reflects the separate interests of its owners). See my article on this distinction at http://www.rogerroyse.com/PDF/MetaphoricalConstructsinLegalAnalysis042502.pdf. The partnership structure preserves the ability to operate as an aggregate of members while limiting those members' personal liability. Removing this aggregate feature (which the proposal would do) will result in a loss of a basic method of structuring business ventures and will require the creation of complex multi entity structures to accomplish the same result.

The defining needs of the entity model are (i) differing risk levels, goals and levels of participation of the stakeholders, (ii) the ability to preserve continuity of interest or ownership in an acquisition, (iii) centralized management, and (iv) the ability to use equity as compensation. Prior to the "check the box" regulations (Treasury Regulations sections 301.7701-1 through 301.7701-3), the tax law recognized the characteristics of a corporation as (i) limited liability, (ii) centralized management, (iii) free transferability of interest, and (iv) continuity of life. While those distinctions may have been forgotten in a "check the box" age, they are useful in determining whether a business venture is more like an entity or more like an aggregate and how it should be taxed. The S corporation as an entity fits many operating businesses since it may have (i) numerous stakeholders, such as founders,

investors, employees and creditors, (ii) a board of directors and selected officers, and (iii) the expectation of exiting via a stock for stock exchange or merger.

The partnership (or limited liability company [LLC] taxed as a partnership) structure, however, is better suited to combinations that are more properly viewed as aggregates of its members. Pooled real estate investment, in particular, is often considered an aggregate of the owners, which is why most real estate is held in LLC or limited partnership form. In fact, if not for the limited liability that LLCs provide, jointly owned real estate would almost always be held as tenants in common ("TIC") interests.

Pooled securities investment vehicles, such as private equity and investment funds, are similarly well suited to aggregate models. In both those cases, the venturers seek to pool their resources for economies of scale or market reasons to acquire and hold for investment, as an aggregate of its owners, the acquired assets. In that regard, partnership structures look more like aggregates than entities, and the tax law has accommodated this market reality in Subchapter K of the Internal Revenue Code of 1986, as amended (the "Code").

The analogy is not perfect, of course, and there are places where partnerships are treated as entities and not aggregates, and S corporations are treated as aggregates and not entities, but the basic distinction has evolved to reasonably fit business practice. Option 2 ignores the fundamental difference between entity and aggregate business combinations.

Specifically, Option 2 is problematic in two main areas. First, the concept of recognizing gain on distributions of appreciated property may fit the entity model, but runs contrary to the type of business that could just as easily be conducted as a TIC pursuant to a co-tenancy agreement. The ability to freely transfer property in and out of a partnership is the single most important distinction in making a choice of entity decision when the business is an appreciating asset such as land or securities. The entity model simply does not work for that kind of business, and those types of businesses will opt for inefficient TIC arrangements before accepting that model.

Secondly, Option 2 proposes to limit the ability to specially allocate gains and losses. Currently, the Code contains numerous restrictions on special allocations to ensure that such allocations must have "substantial economic effect." In the aggregate model, differing stakeholders will regularly accept degrees of risk that may or may not match their percentage ownership in other partnership items. It is fair to allocate gross income and loss to the partners who actually benefit or lose economically. In fact, it would inappropriately shift loss or gain in some cases if such special allocations were not allowed.

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In conclusion, I support the modernization of the S corporation rules to remove artificial impediments to doing business through the S corporation form. However, I oppose the unification of pass-through taxation as unworkable and inefficient.

I am available to testify on tax reform before the full Ways and Means Committee or a subcommittee upon request.

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